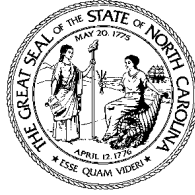




INTRODUCTORY SECTION



State of North Carolina Office of the State Controller

Michael F. Easley, Governor

Robert L. Powell, State Controller

The Honorable Michael F. Easley, Governor
Members of the North Carolina General Assembly
Citizens of North Carolina

It is our pleasure to furnish you with the 2001 Comprehensive Annual Financial Report (CAFR) of the State of North Carolina in compliance with G.S. 143B-426.39. This report has been prepared by the Office of the State Controller. Responsibility for both the accuracy of the data and the completeness and fairness of the presentation, including all disclosures, rests with the State government and this office. To the best of our knowledge and belief, the enclosed data are accurate in all material respects and are reported in a manner designed to present fairly the financial position and results of operations of the various funds and account groups of the State of North Carolina. We believe all disclosures necessary to enable you to gain an understanding of the State's financial activities have been included.

For the convenience of users we have divided this comprehensive annual financial report into three major sections, described as follows:

- The **introductory section** includes this transmittal letter and the State's organization chart, including a listing of principal State officials.
- The **financial section** includes the general purpose financial statements (combined statements, the notes, and the required supplementary information), the combining and individual fund and account group financial statements, and schedules.
- The **statistical section** includes selected financial, non-financial and demographic information, much of which is presented on a ten-year basis, as well as required supplementary information.

State Reporting Entity and Its Services

The State of North Carolina entity as reported in the CAFR includes all fund types and account groups of the departments, agencies, boards, commissions and authorities governed and legally controlled by the State's executive, legislative and judicial branches. In addition, the reporting entity includes legally separate component units for which the State is financially accountable. The component units are discretely presented in the financial statements. The State's discretely presented component units are the University of North Carolina system; the State's community colleges; Golden LEAF and North Carolina Phase II Tobacco Certification Entity (*governmental organizations*); and various proprietary organizations providing specific services to the public and private sector. The criteria for inclusion in the reporting entity and its presentation are defined by the Governmental Accounting Standards Board (GASB) in its GASB Codification Section 2100. These criteria are described in Note 1 of the accompanying financial statements.

The State and its component units provide a broad range of services to its citizens, including public education; higher education; health and human services; economic development; environment and natural resources; public safety, corrections, and regulation; transportation; agriculture; and general government services. The costs of these services are reflected in detail and in summary in this report.

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An Equal Opportunity/Affirmative Action/Americans With Disabilities Employer

Issues and Initiatives

During fiscal year 2000-2001, the Governor, the General Assembly, and the departments and agencies of State government worked to address key issues facing State government and the citizens of North Carolina.

Tax Increases

On September 26, 2001, Governor Easley signed the Current Operations and Capital Improvements Appropriations Act of 2001 (State budget). The newly enacted State budget includes General Fund appropriations of \$14.4 billion for fiscal year 2001-2002, and \$14.8 billion for fiscal year 2002-2003. Actual General Fund appropriation expenditures for fiscal year 2000-2001 were \$13.45 billion.

The General Fund budget for fiscal year 2002 included several tax increases. The State sales tax was increased by a half-cent from 4% to 4.5%. The State hopes to generate an additional \$246.3 million in General Fund revenue for the fiscal year 2002. This increase was effective October 16, 2001, and will expire July 1, 2003. Effective July 1, 2003, the provisions for local government tax reimbursements will be repealed, and local governments will have the optional authority to impose an additional half-cent sales tax. Local governments opting to increase sales tax by a half-cent will be held harmless by the State up to the amount that they would have received during fiscal year 2002-2003 if the statutory provisions related to local government tax reimbursements had not been repealed.

Effective for the tax years January 1, 2001 through December 31, 2003, the highest individual income tax rate will rise from 7.75% to 8.25%, generating an estimated \$125.5 million for the fiscal year 2002. Effective December 1, 2001, a 6% sales tax will be imposed on liquor sold in ABC stores. Effective January 1, 2002, the State will levy a telephone tax on out-of-state long-distance calls. The \$1,500 cap on sales tax on cars will be eliminated effective October 1, 2001. Of these tax increases, the increased state sales tax and income tax increase are expected to generate the largest increase in General Fund revenues.

State Health Plan

The State Health Plan provides comprehensive major medical care for employees and retirees of the State and its participating component units, and it allows for optional coverage of employee and retirees' dependents. This care is also extended to employees and retirees of the Local Education Agencies (LEAs), which are not part of the State's reporting entity. Coverage is self-funded by contributions to the State Health Plan (the Plan), a proprietary component unit of the State. Contributions for employee and retiree coverage are made by the State, its participating component units, and LEAs. Contributions for dependent coverage are made by employees and retirees. Coverage is also extended to certain individuals as an other postemployment benefit. The Plan pays most expenses that are medically necessary and eligible for coverage based on usual, customary and reasonable allowances. Claims are subject to specified annual deductible and copayment requirements. The Plan disallows claims in excess of a lifetime maximum of \$2 million (\$5 million effective July 1, 2001).

As of June 30, 2001, the State Health Plan reflected negative retained earnings of \$159.67 million, with an operating loss of \$212 million for the fiscal year. Insurance premium revenues were \$930.48 million (\$167.15 million increase from fiscal year 2000), while claims and benefits expenses were \$1.127 billion (\$310.55 million increase from fiscal year 2000).

As of July 1, 2001, an estimated \$240 to \$300 million of cost savings for the State Health Plan were implemented in the form of increased insurance premiums, reduction of benefits to employees and dependents, and in the form of cuts in payments to providers. The State Health Plan pays 100% of the health insurance premium for employees and retirees, but employees and retirees must pay for optional family or dependent coverage. Effective October 1, 2001, the insurance premium for dependent coverage rose by 30%.

Historically, the State's health benefits package has been a key component of an overall compensation package enabling the State to hire and retain quality personnel.

Tobacco Settlement

In 1998, North Carolina, along with forty-five other states, signed the Master Settlement Agreement (MSA) with the nation's largest tobacco companies to settle existing and potential claims of the states for damages arising from the use of the companies' tobacco products. The amount that North Carolina will actually receive from this settlement remains uncertain, but projections are that the State will receive approximately \$4.6 billion through the year 2025.

In 1999, the State approved legislation to implement the terms of the MSA in North Carolina. The State created a nonprofit corporation, Golden LEAF (*Long-term Economic Advancement Foundation*), to distribute 50 percent of the settlement funds received by the State of North Carolina. The legislation directed that these funds be used for the purposes of providing economic impact assistance to economically affected or tobacco-dependent regions of North Carolina. Golden LEAF supports programs such as education assistance, job training, employment assistance, alternative crop research, economic hardship assistance, public works, industrial recruiting, health and human services, and community assistance. The Golden LEAF's share of the settlement funds are being put in an endowment that will generate earnings to fund grants. Golden LEAF may also use a portion of the principal to fund grants in the future. During the fiscal year ended June 30, 2001, Golden LEAF awarded \$5.1 million in grants to 34 organizations. At June 30, 2001, Golden LEAF had an unreserved fund balance of \$167.1 million.

In 2000, the State enacted legislation that established the Health and Wellness Trust Fund and the Tobacco Trust Fund. Each fund will receive 25 percent of the tobacco settlement payments. The purpose of the Health and Wellness Trust Fund is to finance programs and initiatives to improve the health and wellness of the people of North Carolina. The State is planning to spend a substantial portion of the Health and Wellness Trust Fund money over the next two to three years on a prescription drug plan for the elderly, a plan the Governor strongly supports. In addition, some of the money is likely to be spent on anti-smoking efforts. North Carolina has the third-highest rate of adult tobacco use in the nation. The primary purpose of the Tobacco Trust Fund is to compensate the tobacco-related segment of North Carolina's economy for the economic hardship it is expected to experience as a result of the MSA. At June 30, 2001, the Health and Wellness Trust Fund and the Tobacco Trust Fund had unreserved fund balances of \$73.8 million and \$85.6 million, respectively.

Hurricane Floyd

Hurricane Floyd passed through the eastern portion of North Carolina in September 1999. Hurricane and tropical force winds, torrential rains, and flooding left one-third of North Carolina suffering from an unprecedented natural disaster. The record-high floodwaters of Hurricane Floyd forced thousands of people from their homes. Many citizens lost homes, farms, and businesses. On December 16, 1999, the General Assembly held a special session for the purpose of setting aside \$836.6 million of funds for recovery from damage caused by the winds, rain, and flooding of Hurricane Floyd. Funds were allocated in the following categories and amounts: housing/rental expenditures, \$446.3 million; State match of federal funds, \$162.2 million; agriculture and fisheries, \$98.3 million; local government assistance, \$37.8 million; small business, \$36.7 million; and various other programs, \$55.3 million. As these funds flow into the economies of the areas affected by Hurricane Floyd, income and sales taxes should offset some portion of the cost of our disaster recovery effort. At June 30, 2001, the State's General Fund (*budgetary basis*) held \$448.6 million in reserve for disaster relief (*Hurricane Floyd, Fall 1999, and Hurricane Fran, Fall 1996*).

General Obligation Debt

On September 1, 2000, \$300 million in Public Improvement Bonds, Series 2000A were issued, representing a consolidation of Public School Building Bonds in the amount of \$295 million and Natural Gas Bonds in the amount of \$5 million. The bonds were issued at rates ranging from 5.0% to 5.1% with a final maturity of September 1, 2018.

In November 2000, the State's voters approved \$3.1 billion of University and Community College general obligation bonds. The \$3.1 billion is projected to be issued over the six-year period beginning in fiscal year 2000-01, with repayments scheduled for fiscal year 2001-02 through fiscal year 2024-25. Total debt service for all of the State's outstanding general obligation debt is projected to be at its highest in fiscal year 2006-07, at \$722 million (*assuming no additional voter approved debt in subsequent years*). At June 30, 2001, the State's outstanding general obligation debt totaled \$3.039 billion, with an additional \$4.37 billion approved and unissued at June 30, 2001. Outstanding general obligation debt is projected to peak at \$6.043 billion for fiscal year 2005-06. The General Assembly has predetermined the specific building projects to be funded by the bond proceeds. The bond legislation will require many local governments to partially match funds targeted for new community college buildings. The matching requirement is reduced or eliminated for low-wealth counties and for counties that have exceeded historic match requirements. Community college repair and renovation projects do not have matching requirements.

On March 1, 2001, \$380 million in Public Improvement Bonds, Series 2001A were issued, representing a consolidation of Public School Building Bonds in the amount of \$100 million, Clean Water Bonds in the amount of \$30 million, and Higher Education Bonds in the amount of \$250 million. The bonds were issued at rates ranging from 4.5% to 5.0% with a final maturity of March 1, 2019.

Bonds Authorized, Issued, and Unissued

June 30, 2001

(Expressed in Thousands)

Authorized:	Date	School Construction	Higher Education	Highway Construction	Clean Water	Natural Gas	Total
School Construction	11/5/96	\$ 1,800,000	\$ —	\$ —	\$ —	\$ —	\$ 1,800,000
Highway Construction	11/5/96	—	—	950,000	—	—	950,000
Clean Water	11/3/98	—	—	—	800,000	—	800,000
Natural Gas	11/3/98	—	—	—	—	200,000	200,000
University/Community College	11/7/00	—	3,100,000	—	—	—	3,100,000
Total Authorized		1,800,000	3,100,000	950,000	800,000	200,000	6,850,000
Issued:							
Public School Building Series 1997A	3/1/97	450,000	—	—	—	—	450,000
Highway Bonds, Series 1997A	11/1/97	—	—	250,000	—	—	250,000
Public School Building Series 1998A	4/1/98	450,000	—	—	—	—	450,000
Public School Building Series 1999	4/1/99	450,000	—	—	—	—	450,000
Public Improvement, Series 1999A	9/1/99	—	—	—	172,400	5,000	177,400
Public Improvement, Series 1999B	9/1/99	—	—	—	—	20,000	20,000
Public Improvement, Series 1999C	10/1/99	—	—	—	2,600	—	2,600
Public Improvement, Series 2000A	9/1/00	295,000	—	—	—	5,000	300,000
Public Improvement, Series 2001A	3/1/01	100,000	250,000	—	30,000	—	380,000
Total Issued		1,745,000	250,000	250,000	205,000	30,000	2,480,000
Unissued — June 30, 2001		\$ 55,000	\$ 2,850,000	\$ 700,000	\$ 595,000	\$ 170,000	\$ 4,370,000

Construction and Other Commitments

At June 30, 2001, the State had commitments of \$1,597.7 million for construction of highway facilities. Of this amount, \$1,185.9 million relates to the Highway Fund, and \$411.8 million relates to the Highway Trust Fund. The other commitments for construction and improvements of State government facilities totaled \$444.4 million (including \$393.1 million for the Department of Environment and Natural Resources, \$12.4 million for the Department of Correction, and \$11.5 million for the Department of Public Instruction). At June 30, 2001, the University of North Carolina system (component unit) had outstanding construction commitments of \$392.4 million (including \$121.7 million for University of North Carolina - Chapel Hill, \$61.6 million for East Carolina University, and \$37.2 million for UNC Hospitals). At June 30, 2001, community colleges (component units) had outstanding construction commitments of \$94.1 million (including \$21.3 million for Wake Technical Community College,

\$20.4 million for Cape Fear Community College, and \$13.2 million for Johnston Community College). At June 30, 2001, proprietary component units had outstanding commitments of \$31.6 million (including \$15.6 million for NC State Ports Authority and \$10.0 million for NC Global Transpark Authority).

Litigation

Leandro et al v. State of North Carolina and State Board of Education — Right to a Sound Basic Education. Leandro et al v. State of North Carolina and State Board of Education — Right to a Sound Basic Education. In 1994, students and boards of education in five counties in the State filed suit in Superior Court requesting a declaration that the public education system of North Carolina, including its system of funding, violates the State constitution by failing to provide adequate or substantially equal educational opportunities, by denying due process of law, and by violating various statutes relating to public education. Five other school boards and students therein intervened, alleging claims for relief on the basis of the high proportion of at-risk and high-cost students in their counties' systems.

The suit is similar to a number of suits in other states, some of which resulted in holdings that the respective systems of public education funding were unconstitutional under the applicable state law. The State filed a motion to dismiss, which was denied. On appeal the North Carolina Supreme Court upheld the present funding system against the claim that it unlawfully discriminated against low wealth counties but remanded the case for trial on the claim for relief based on the Court's conclusion that the constitution guarantees every child the opportunity to obtain a sound basic education. Trial on the claim of one plaintiff-county was held in the fall of 1999. On October 26, 2000, the trial court, in Section Two of a projected three-part ruling, concluded that at-risk children in North Carolina are constitutionally entitled to such pre-kindergarten educational programs as may be necessary to prepare them for higher levels of education and the "sound basic education" mandated by the Supreme Court. On March 26, 2001, the Court issued Section Three of the three-part ruling, in which the judge ordered all parties to investigate certain school systems to determine why they are succeeding without additional funding. The State filed a Notice of Appeal to the Court of Appeals, which resulted in the Court's decision to re-open the trial and call additional witnesses. That proceeding took place in the fall of 2001. The result of this last proceeding is unknown at this time; however, the cost of future programs which the Court may order could exceed \$100 million.

N.C. School Boards Association, et. al. v. Harlan E. Boyles, State Treasurer, et. al. — Use of Administration Payments. On December 14, 1998, plaintiffs, including county school boards of Wake, Durham, Johnston, Buncombe, Edgecombe and Lenoir Counties, filed suit in Superior Court requesting a declaration that certain payments to State administrative agencies must be distributed to the public schools on the theory that such amounts are civil penalties which under the North Carolina Constitution must be paid to the schools.

For the last fiscal year for which information was available to them, plaintiffs allege liability of approximately \$84 million. Until this matter is resolved, any refunds and interest will continue to accrue. The North Carolina Attorney General's Office believes that sound legal arguments support the State's position on the outstanding claims.

Faulkenbury v. Teachers' and State Employees' Retirement System, Peele v. Teachers' and State Employees' Retirement System, and Woodard v. Local Governmental Employees' Retirement System — Disability Retirement Benefits. The plaintiffs are disability retirees who brought class actions in State court challenging changes in the formula for payment of disability retirement benefits and claiming impairment of contract rights, breach of fiduciary duty, violation of other federal constitutional rights, and violation of state constitutional and statutory rights. The Superior Court ruled in favor of the plaintiffs. The Order was affirmed by the North Carolina Supreme Court in 1997. The case went back to the Superior Court for calculations of benefits and payment of retroactive benefits, along with determination of various remedial issues. As a result of the remedial proceedings, there have been two appeals to the appellate courts concerning calculation of the retroactive benefits. The plaintiffs previously submitted

documentation to the court asserting that the cost in damages and higher prospective benefit payments to the plaintiffs and class members would amount to \$407 million. Calculations and payments so far indicate that retroactive benefits will be significantly less than estimated, depending in part on the pending appeal. Payments have been made by the State in excess of \$83 million. A liability of \$31.5 million for the retroactive benefits has been booked in the Teachers' and State Employees Retirement System.

Other Litigation. The State is involved in numerous other claims and legal proceedings, many of which normally recur in governmental operations. A review of the status of outstanding lawsuits involving the State by the North Carolina Attorney General did not disclose other proceedings that are expected to have a material adverse effect on the financial position of the State.

New Governmental Reporting Model Infrastructure Reporting

For the fiscal year ending June 30, 2002, the State and its component units, will implement *GASB Statement No. 34, Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments (GASB Statement No. 34)* along with several other related new GASB statements. The implementation of this new accounting standard will represent a drastic change in the presentation of the financial statements prepared in accordance with generally accepted accounting principles (GAAP). However, this new standard will have no effect on the presentation of the State's budgetary financial operations. In addition to the State's general government agencies, the accounting and financial reporting for the State's community colleges (*component units*), and the campuses of the University of North Carolina System (*component unit*) will also be affected by this new GASB standard.

In relation to the fund-level financial statements, and in particular to funds currently classified in the special revenue funds and internal service funds, the State will be working to take advantage of efforts related to required fund definition and classification changes. In the area of GAAP-based fund classification, we hope to accommodate a more realistic and practical view of fund classification for our financial statements prepared in accordance with generally accepted accounting principles. Most state and local governments operate on a non-GAAP, budgetary basis. It is common for governments to have differences in fund classification for their non-GAAP, budgetary financial statements and their GAAP-based financial statements. These differences must be presented and reconciled in the notes to the financial statements (see **Note 2**).

An important aspect of the new standard is the requirement to provide information about infrastructure assets. Infrastructure assets are long-lived capital assets that are stationary in nature and normally can be preserved for a significantly greater number of years than most capital assets. Examples of infrastructure include roads, bridges, tunnels, drainage systems, water and sewer systems, dams, and lighting systems. Our primary focus related to infrastructure will necessarily be the State's roads and highway systems, at the N.C. Department of Transportation.

Minimum requirements will call for an inventory and categorization of the State's major road and highway systems, and an objective assignment of costs and useful lives to the State's major infrastructure assets. The Department of Transportation's accounting system will need to be capable of capturing and maintaining this information. By June 30, 2006, the State will be required to reflect the major infrastructure assets, with related depreciation and accumulated depreciation, acquired or significantly reconstructed, or that received significant improvements since July 1, 1980, on its financial statements. This undertaking will be no small task.

The new GASB Statement No. 34 is a priority topic for state auditors, state treasurers and state controllers. A task force of the National Association of State Auditors, Comptrollers and Treasurers (NASACT) is continuing its work to solve the implementation issues presented by GASB Statement No. 34.

***North Carolina
Highway
System:
Condition
Assessment
and Funding***

A major new financial reporting requirement for governments, discussed above, is the inclusion of infrastructure assets in governments' financial statements, to include depreciation and accumulated depreciation. Our State is moving towards implementation of GASB Statement No. 34 by recording the highway system using the historical cost method with depreciation.

Our State road system includes an estimated 78,245 miles of roads. The Department of Transportation is required by G.S. 136-44.3 to survey and report on the condition of the State highway system. This report provides estimates of :

- (1) The annual cost of routine maintenance of the State highway system;
- (2) The cost of eliminating any maintenance backlog by categories of maintenance requirements;
- (3) The annual cost to resurface the State highway system based upon a 12-year repaving cycle for the primary system and a 15-year cycle for other highways; and
- (4) The cost of eliminating any resurfacing backlog, by type of system.

On the basis of this report, the North Carolina Department of Transportation develops a statewide annual maintenance program for the State highway system, which is subject to the approval of the North Carolina Board of Transportation and takes into consideration the general maintenance needs, special maintenance needs, vehicular traffic, and other factors deemed pertinent. Transportation engineers, at the end of the fiscal year, certify the maintenance of highways in each division in accordance with an annual work program, along with explanations of any deviations. The report on the condition of the State highway system and the annual maintenance program are presented to the Joint Legislative Transportation Oversight Committee by November 30 of each even-numbered year. A detailed assessment is conducted of the State's pavements, structures, and roadway features. The methodologies used in the survey and assessment are based on acceptable practices used in other state transportation departments across the country.

The *2000 Report on the Condition of the State Highway System* concludes that the condition of the State highway system is directly related to the level of funding, and that current funding levels for routine maintenance and resurfacing are inadequate. In a high growth state such as North Carolina, the trend of increasing lane miles and increased traffic on existing roads, along with general deterioration from the elements, are at the heart of the problem.

The most current *Condition* report suggests that while road maintenance funding has increased over the last decade, the increase in funding has not kept pace with inflation. According to the December 2000 report, \$500.2 million is needed to fund routine maintenance and to provide for an acceptable level of transportation service in North Carolina. According to the report, it would take an additional \$214.4 million (\$21.4 million per year) over the next 10 years to eliminate the current road maintenance backlog, with an additional \$75.6 million (\$7.56 million per year) needed over the next 10 years to eliminate the contract resurfacing backlog. The annual cost of resurfacing the State's primary, secondary, and urban road systems is \$221.4 million.

The estimated total maintenance needs, including backlogs, ranges from \$785.6 million in fiscal year 2001-2002, to \$1.116 billion in fiscal year 2009-2010 (averaging \$935.72 million per year). For the year ended June 30, 2001, \$531.4 million was spent on road maintenance. The approved State budget included \$578.6 million of road maintenance funding for fiscal year 2001-2002.

Economic Condition and Outlook

National Situation

The longest postwar expansion since the 1960's ground to a halt in 2001 as the nation entered a recession in the third quarter. The shift in the nation's economic fortunes occurred in two stages.

First, the combination of higher energy prices, tight money, and the tech stock crash (the so-called "Perfect Storm") led to the beginnings of the "soft landing" that the Federal Reserve had been trying to engineer. For a while, the continued strength in consumer spending and the housing sector offset the drop in capital spending that resulted from profit declines and excess capacity. This led economists to speak in terms of the potential for a short-lived "inventory correction."

Helping the situation was the unprecedented actions of the Federal Reserve Board ("Fed"). After raising short-term interest rates from 4¾% to 6½% between June 1999 and July 2000 to slow the economy, the Fed became increasingly worried in late 2000 about the steep decline in many economic indicators. While some drop was expected, there was a perceived danger that the slowdown was spiraling out of control. To respond, the Fed cut the short-term interest rates by one-half percent in early January. Underscoring the Fed's concern was the fact that this decision took place weeks prior to the regularly scheduled meeting of the Federal Open Market Committee.

As the economy continued to worsen, rates were lowered in half point increments on four other occasions, with some of the cuts taking place prior to scheduled policy meetings. The speed with which the changes took place was unusual for an institution that has been known for sometimes not responding quickly enough to worsening conditions. In addition to the rate cuts, the Fed was pumping liquidity into the economy by adding to reserves in the banking system.

One reason the Fed acted so quickly was that it normally takes at least nine months for rate cuts to have a noticeable effect on the real economy (jobs, retail sales). In addition, there may have been a feeling among Fed officials that a serious recession would wipe out the legacy established during the Greenspan years. A complicating factor may have been the fact that monetary authorities had never experienced a technology sector crash of the current magnitude.

Aggressive monetary policy coupled with falling energy prices, the \$600 federal tax rebates and a leveling off of stock prices led many economists to believe that a recovery would begin by the fourth quarter of 2001. In fact, just prior to September 11, a number of closely watched economic indicators began to suggest that a recovery had begun, or was in the process of starting.

All of this changed on September 11.

For the first few days, people were completely focused on news reports. This meant that workers were not producing, consumers stopped going to the malls, and the nation's transportation system was effectively shut down.

A few days later, workers began returning to their duties and retail sales began picking up. The problem was that people were still very nervous about the possibility of other acts of terrorism. The subsequent drop in consumer confidence, similar to that experienced during the 1990 buildup to the Gulf War, was enough to push the already weakened economy into a full-blown recession.

The unique nature of the current situation makes it difficult to predict where the economy is headed in 2002. If other terrorist acts take place, or the military gets bogged down in a long and costly war, the recovery may take some time. At the same time, the massive amount of federal stimulus coming from two tax cut packages this year, rebuilding assistance for New York City, additional discretionary spending and continued interest rate reductions almost guarantees a

strong national recovery once consumers and businesses begin to feel more secure. In fact, one well-known forecasting firm calculates the stimulus from the additional spending and tax cuts at 2.25% economic growth. This is more than the Reagan package in the early 1980's and does not include the impact of interest rate cuts.

State Perspective

The North Carolina outlook depends on two conflicting features of the state's economy. First, continued diversification means that the state's prospects are more in line with the national fortunes as outlined earlier. At the same time, our economy remains more dependent on traditional manufacturing industries and thus is more cyclical than the U.S. This leads to steeper downturns and stronger recoveries.

The diversification of the state's economy during the last four decades can be best illustrated by the fact that in 1970, 46% of the workforce was employed in manufacturing. Today the share is down to 18%, and the trend has accelerated in recent years. In addition, the proportion of manufacturing workers employed in textile, apparel, furniture, and tobacco has dropped from 63% in 1970 to 34% in 2000.

The adjustment within manufacturing has been helpful in alleviating the damage from the movement of traditional manufacturers to Mexico and other overseas locations. At the same time, the collapse of the technology-related firms during this recession is having a larger impact than in previous downturns.

The best example of this latter effect is the rise in the unemployment rate in Catawba County from 2.2% in July 2000 to 7.2% in the same month this year. The Catawba Valley area, home to major fiber optic production facilities, has been hammered during the last year due to excess capacity problems in the telecommunication sector.

The continued diversification of the state's economy is essential to the well-being of North Carolinians in the near-term. However, North Carolina still has 18% of employment in manufacturing, versus 12% for the nation as a whole. This is the main reason why our statewide unemployment rate of 5.2% is now above the national average (4.9%). For most of the 1990's, our rate was consistently a point or so below the U.S.

There may be a silver lining to the cyclical nature of the North Carolina economy: our recoveries tend to be stronger than other states. For example, during the first two years of the recovery from the 1981-82 recession, the income of the State's residents ("personal income") grew 33% faster than the U.S. In the same period following the 1990-91 recession, our economy rose 46% faster. In fact, our combined growth rate for 1992 and 1993 was the fifth highest in the U.S. It is very possible that if the nation experiences a strong economic recovery in 2002 and North Carolina follows the traditional pattern, we could have a very improved situation by the middle of next year.

A specific North Carolina trend that we need to watch is the slowing employment gains in the financial group (finance, insurance, real estate) and in services in recent years. From 1995-98, high growth in these sectors (over 8% during one quarter) offset the long-term decline in traditional North Carolina manufacturing industries.

State Economic Data

However, in 1999 the impact of mergers and consolidations in banking and health care led to a sharp drop in the rate of growth of non-manufacturing employment. What we do not know at this time is whether this trend will continue once the overall economy begins a recovery.

The single most important state economic factor for the State budget is wage and salary payments. This source of income makes up 74.8% of taxable income in North Carolina. Expressed another way, about 40% of the General Fund revenue base is tied to net withholding payments (gross payments less refunds) and withholding is directly related to wage payments.

For the 1995-99 period, wages and salaries paid by employers grew at an average annual rate of 7.5%. Even during 2000, the rate of increase amounted to 7.2%. The reason for the stability through 2000 was the fact that average pay rates were still increasing at a rate of almost 4%, and employment changes always lag changes in the overall economy. Thus, unemployment did not begin to accelerate until late in the downturn.

A review of Employment Security Commission data indicates that the employment slowdown has begun. For the first quarter of 2001, wage and salary growth dropped to 4.9%. Based on withholding tax receipts, we think that the rate of increase for the second quarter was 3.8% and 2.6% for the third quarter.

Slower wage and salary growth is due partly to smaller increases in employment. For example, nonagricultural employment in North Carolina was 1.9% higher in July 2000 than for the same month the prior year. Tentative data for July 2001 indicates that the increase slowed to .3%. This report does not include data from start-up firms. However, even if an adjustment is made for this factor, net job growth in the state is no higher than 1.1%. A more serious problem is the fact that average weekly hours worked in manufacturing has declined from almost 41 hours in July 2000 to 39 hours this year, a 4.4% reduction.

Since sales tax collections amount to another 25% of the revenue base, the drop in retail sales activity in the State is important. The measure used by the General Assembly's Fiscal Research Division is gross state and local sales tax collections prior to refunds to local government and nonprofits. Throughout 2000, consumer spending was a stabilizing force in the overall economy, even as corporate profits and stock prices took a nosedive. As recently as the first quarter of 2000, sales tax receipts were growing at a 3.4% annual rate.

The bottom dropped out of consumer spending during the Spring. For the April-July period, taxable sales fell at a 2.2% annual rate. In August, receipts were up .6% due to the \$600 federal tax rebates. If the events of September 11 had not taken place, we might have continued to experience modest positive growth in retail sales as the remainder of the refund checks were distributed.

Now we are facing a different situation. In September, state and local sales tax collections fell at a 3.8% annual rate. In October, the rate of decline was 1.4%. Data for these two months captures the August 16 – October 15 sales period for large merchants and August 1 – September 30 for smaller vendors. The data clearly indicates the impact of the events since September 11 on consumer confidence and shopping activity.

During the last downturn, tight monetary policy and the elimination of incentives caused car and light truck registrations in North Carolina to fall from 433,477 units in the 1987-88 fiscal year to 405,776 in 1988-89 and then to 360,929 in 1989-90. When the Gulf War recession hit, sales dropped another 17% to 299,757.

This time around, consumer spending has been a stabilizing force, as reflected in stronger-than-expected auto sales. For example, vehicle registrations peaked at a record level of 493,778 during the 1999-2000 fiscal year. Part of this strength was gains to investors from the roaring

stock market and the exercise of stock options. For 2000-01, the level of sales dropped 7% to 459,300 units, a modest decline for an economic downturn. To counter the effects of September 11, manufacturers are now offering zero percent financing. Nationwide, this has pushed sales back to the highest level in recent years.

— *Economic analysis prepared by David Crotts*
Fiscal Research Division
North Carolina General Assembly
November 1, 2001

Financial Information

Internal Control

Management of the government is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of the State are protected from loss, theft or misuse and to ensure that adequate accounting data are compiled to allow for the preparation of financial statements in conformity with generally accepted accounting principles. The internal control structure is designed to provide reasonable, but not absolute, assurance that these objectives are met. The concept of reasonable assurance recognizes that: (1) the cost of a control should not exceed the benefits likely to be derived, and (2) the valuation of costs and benefits requires estimates and judgments by management.

As a recipient of federal financial assistance, the State also is responsible for ensuring that an adequate internal control structure is in place to ensure compliance with applicable laws and regulations related to those programs. This internal control structure is subject to periodic evaluation by management, internal audit staff, and independent auditors of the government.

Budgetary Control

In addition, the State maintains budgetary controls. The objective of these budgetary controls is to ensure compliance with legal provisions embodied in the annual appropriated budget approved by the General Assembly. Activities of the General Fund and most departmental special revenue funds are included in the annual appropriated budget. The State Highway Fund and the Highway Trust Fund, the State's major special revenue funds, are primarily budgeted on a multi-year basis. Capital projects are funded and planned in accordance with the time it will take to complete the project. The level of budgetary control (that is, the level at which expenditures cannot legally exceed the appropriated amount) is exercised at both the departmental and university level by way of quarterly allotments, with allotment control exercised by the State Controller, and on the program line-item levels requiring certain approvals by the Director of the Budget. Legislative authorization of departmental expenditures appears in the State Appropriation Bill. This "Certified Budget" is the legal expenditure authority; however, executive changes to the legal budget may be approved by the Office of State Budget and Management (OSBM). This results in the "Final Budget" presented in the financial statements.

GAAP Accounting

Although the State budgets and manages its financial affairs on the cash basis of accounting, G.S. 143-20.1 requires the Office of the State Controller to prepare a comprehensive annual financial report (CAFR) in accordance with generally accepted accounting principles (GAAP). Furthermore, the Governmental Accounting Standards Board and the nation's financial community have encouraged states to present, in their annual reports, financial statements of the governmental funds that are prepared on the modified accrual basis of accounting, following generally accepted accounting principles. Under this basis, which more adequately serves the financial community's analytical and other needs, revenues are recognized when they become both measurable and available to finance operations of the fiscal year, or to liquidate liabilities existing at fiscal year-end. Generally, expenditures are recognized when a liability is incurred. Except for exhibits and notes clearly labeled otherwise, this CAFR has been prepared in accordance with GAAP.

Results of Operations

General Governmental Funds

Revenues and Other Financing Sources

Revenues and other financing sources for general governmental functions (*General Fund, special revenue funds, and capital projects funds*) amounted to \$27.925 billion for the fiscal year ended June 30, 2001, using the modified accrual basis of accounting. The major categories of revenues and other financing sources are shown in the following table. Amounts are expressed in millions.

	<u>Amount</u>	<u>Percent of Total</u>
Revenues:		
Taxes.....	\$ 15,147	54.2%
Federal funds.....	7,925	28.4%
Local funds.....	761	2.7%
Investment earnings.....	488	1.7%
Fees, licenses and fines.....	896	3.2%
Tobacco settlement.....	140	0.5%
Other.....	<u>435</u>	1.6%
Total revenues.....	<u>25,792</u>	92.3%
Other Financing Sources:		
Operating transfers in and other sources.....	1,453	5.2%
Proceeds from bond sale.....	<u>680</u>	2.5%
Total other financing sources.....	<u>2,133</u>	7.7%
Total Revenues and Other Financing Sources.....	<u><u>\$ 27,925</u></u>	100.0%

Tax Revenues. Tax revenues increased by \$578 million in 2001 to \$15.147 billion, a 4% increase over 2000. Individual income tax collections in the General Fund increased by \$508 million in 2001 to \$7.6 billion, a 7.16% increase over 2000. Sales tax collections in the General Fund grew by \$68 million in 2001 to \$3.43 billion, a 2.03% increase over 2000, compared to a .57% increase from 1999 to 2000. Highway taxes were \$1.705 billion in fiscal year 2001, \$111.2 million, or 6.98% more than in 2000.

Federal Funds. Federal funds revenues grew by \$672 million in 2001 to \$7.925 billion, up by 9.3% over 2000. Increases in Federal revenues are due to increased Federal program expenditures for which the State is reimbursed.

Investment Earnings. Investment earnings of \$488 million reflect a decrease of \$13 million in 2001 from the previous year. Investment earnings include realized/unrealized gains and/or losses, and distributed and accrued interest on cash and investments.

Tobacco Settlement. The State recognized tobacco settlement revenue of \$140.272 million in fiscal year 2001 in the General Fund. Of this amount, \$70.136 million was transferred to the Golden LEAF (*component unit*), with \$35.068 million transferred to the Health and Wellness Trust Fund (*special revenue fund*) and \$35.068 million transferred to the Tobacco Trust Fund (*special revenue fund*). See **Note 18G**.

Expenditures and Other Financing Uses

Expenditures and other financing uses for general governmental purposes totaled \$28.136 billion in 2001, using the modified accrual basis of accounting. The major categories of expenditures and other financing uses, by function, are shown in the following table. Amounts are expressed in millions.

	Amount	Percent of Total
Expenditures:		
Current:		
General government.....	\$ 1,035	3.7%
Education.....	6,965	24.8%
Health and human services.....	9,617	34.2%
Economic development.....	454	1.6%
Environment and natural resources.....	459	1.6%
Public safety, corrections, and regulation.....	1,948	6.9%
Transportation.....	2,820	10.0%
Agriculture.....	89	0.3%
Tax judgments.....	59	0.2%
Capital outlay.....	155	0.6%
Debt service.....	281	1.0%
Total expenditures.....	<u>23,882</u>	84.9%
Other Financing Uses:		
Operating transfers out and other uses.....	1,428	5.1%
Operating transfers to component units.....	<u>2,826</u>	10.0%
Total other financing uses.....	<u>4,254</u>	15.1%
Total Expenditures and Other Financing Uses.....	<u>\$ 28,136</u>	100.0%

Significant changes in expenditures. The trend of increases in expenditures, an increase of \$1.214 billion for 2001, was directly related to the continued emphasis on education (\$290 million increase) and health and human services (\$1.2 billion increase). General government expenditures decreased by \$195 million, or 15.9%. The largest part of this decrease relates to a decrease in expenditures for employer pension contributions of \$129 million.

Educational expenditures (K-12) increased by \$290 million largely because of enrollment growth, increased teacher compensation, increases in the number of teaching positions, and the general increase in dollars spent on State administered programs and costs associated with providing public education. Health and human services increased by \$1.2 billion in 2001. This large increase can be attributed to the increased costs of health care and increased numbers of eligible program beneficiaries related to Medicaid.

Transportation expenditures increased in fiscal year 2001 by \$221 million to \$2.82 billion, or 8.5%. During fiscal year 2000-2001, 162 miles of roads were added to the State highway system, which now consists of 78,245 miles of roads. As the State continues to add road miles to accommodate economic growth, road maintenance requirements will force transportation expenditures to increase.

Debt service increased \$16 million from 2000 to 2001 and will continue to climb as the State continues to issue general obligation debt to fund capital projects for education, highways and utilities.

Additional information, in greater detail and for the past ten years, may be examined in the statistical section.

General Fund

GAAP Fund Balance

The fund balance of the General Fund declined by \$298.1 million in 2001. Expenditures and transfers out exceeded revenues and transfers in by \$239 million. Total assets at June 30, 2001, were \$4.513 billion, with total liabilities at \$4.545 billion. Tax refunds payable were \$951 million in 2001, as compared to \$1.0129 billion in 2000.

Fiscal year 2000 tax refunds payable includes \$100 million of individual income tax refunds deferred for payment to fiscal year 2000-2001 due to processing delays, and \$20 million in corporate income tax refunds delayed to balance the General Fund budget on a cash basis.

In an average year, taxpayer refunds as a percent of gross cash collections approximate 13.5% for individual income tax; just over 8% for corporate income tax; and 5.5% for sales and use tax. These rates of overcollection are the result of the State's tax policies, tax withholding and estimating tables, and in some cases, the desire of the taxpayer to receive a refund at the end of the tax year.

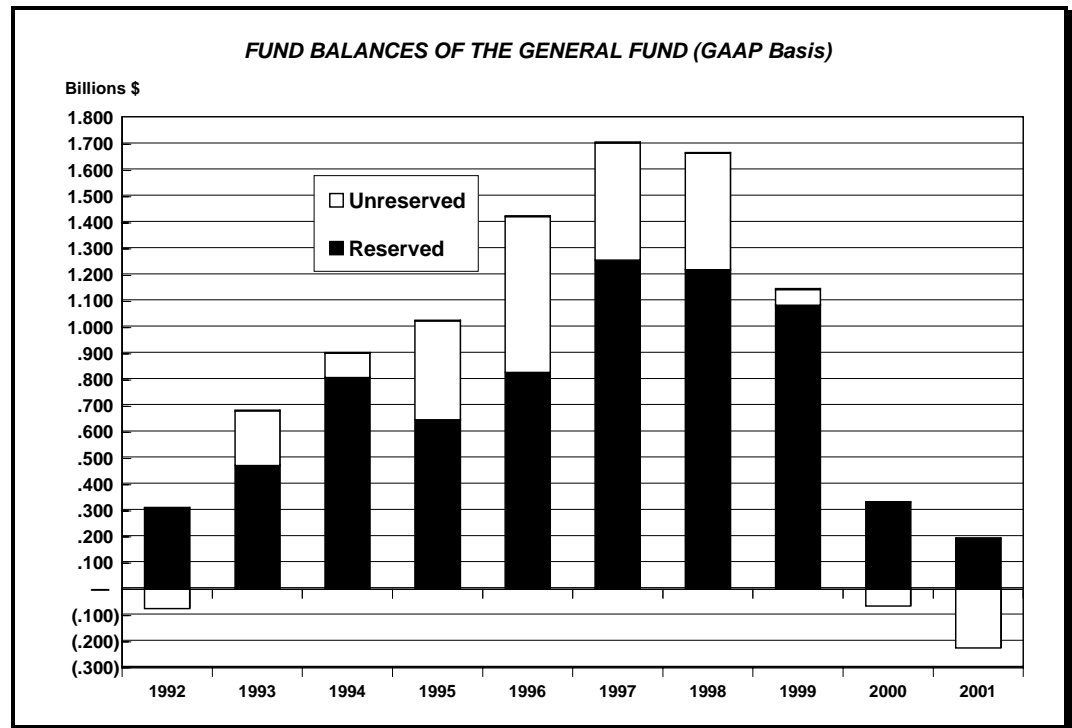
At June 30, 2001, total fund balance of the General Fund on the modified accrual basis was a negative \$32.4 million, in comparison to a \$265.7 million balance at the end of 2000.

The State's unreserved fund balance designations in the General Fund represent tentative plans for use in a future period. The State's internal governing body (*General Assembly*) establishes restrictions on the use of these assets which are reported as fund balance designations. Fund balance designations in the General Fund are established based on the amount of reserves available as measured on the budgetary basis of accounting and authorized carryforwards for continuing General Fund programs. These designations totaled \$608.971 million. As shown in the table below, the unreserved fund balance available to be designated was a negative \$224.922 million on a modified accrual basis (dollars in thousands):

<u>Unreserved Designated Fund Balance</u>	<u>General Fund</u>
Disaster relief.....	\$ 448,608
Educational programs.....	77,918
Other purposes.....	25,159
Public safety, corrections, and regulation programs.....	22,749
Health and human services programs.....	22,415
General government programs.....	7,553
Economic development programs.....	3,399
Disproportionate share.....	1,170
Total designations.....	<u>\$ 608,971</u>
Unreserved fund balance, Exhibit A-1.....	<u>\$ (224,922)</u>

Restrictions in the form of reserves of \$192.5 million, exceeded total fund balance of negative \$32.4 million, resulting in a negative \$224.9 million unreserved fund balance. The State's liabilities to creditors and restrictions/designations of fund balance (equity) exceed the State's assets as determined by generally accepted accounting principles by a total of \$833.893 million.

The following chart illustrates the fund balances on the modified accrual (GAAP) basis of the General Fund for the last ten fiscal years.



Budgetary Fund Balance

For fiscal year 2000-2001, the General Fund closed the year with a zero unreserved fund balance (*second consecutive fiscal year end*). This compares to June 30, 1991, when the General Fund unreserved fund balance was \$441 thousand. North Carolina is required by its constitution to balance the General Fund on a budgetary basis. The budgetary basis reserved fund balance totaled \$871.249 million (see table below). See **Note 2** of the Notes to the Financial Statements for a more detailed discussion of our State's budgetary process. The following schedule summarizes current year changes in the budgetary reserve accounts. Amounts are expressed in thousands.

General Fund Reserved Fund Balance	Balance June 30, 2000	Increases		(Decreases)		Balance June 30, 2001
		Transfers from General Fund Unreserved Fund Balance	Unbudgeted Revenues	Transfers to General Fund Unreserved Fund Balance	Unbudgeted Expenditures	
Savings.....	\$ 37,522	\$ 120,000	\$ —	\$ —	\$ —	\$ 157,522
Retirees' health premium...	117,746	—	—	—	(63,851)	53,895
Repairs and renovations....	7,052	—	—	(4,458)	(2,594)	—
Intangibles tax refunds.....	240,000	—	—	(240,000)	—	—
N.C. Railroad acquisition...	42,000	—	—	—	(10,418)	31,582
N.C. Railroad dividends.....	918	—	—	(918)	—	—
Clean water management..	1,054	—	—	(1,054)	—	—
Disproportionate share.....	1,170	—	—	—	—	1,170
Disaster relief.....	—	448,608	—	—	—	448,608
Exec. Order #3.....	—	—	178,472	—	—	178,472
Total.....	\$ 447,462	\$ 568,608	\$ 178,472	\$ (246,430)	\$ (76,863)	\$ 871,249

Budgetary Savings Reserve Account

During the 1991 session, the General Assembly established a Savings Reserve Account as a restricted reserved portion of fund balance in the General Fund, becoming effective for the year ended June 30, 1992. Under this legislation, one-fourth of any unreserved credit balance (defined by the General Statutes as "...the credit balance, as determined on a cash basis, not already reserved to the Savings Reserve Account.") remaining in the General Fund at the end of each fiscal year will be transferred to the Savings Reserve until the account contains funds equal to 5% of the amount appropriated to the General Fund operating budget for the preceding year. For the fiscal year ended June 30, 1999, the General Assembly delayed the \$40.4 million deposit into the Savings Reserve Account, leaving the total reserve at \$522.5 million. For fiscal year 1999-2000, the General Assembly voted to use \$200 million from the Savings Reserve Account to be appropriated to fund the first installment payment resulting from the intangibles tax cases in which the State received adverse rulings (See *Intangibles Tax Ruling* above). An additional \$286 million was withdrawn from the Savings Reserve Account during fiscal year 1999-2000 to provide for General Fund commitments (*Hurricane Floyd*). At June 30, 2000, an additional \$967 thousand was credited to the Savings Reserve Account. The General Assembly appropriated an additional \$120 million to the Savings Reserve Account for fiscal year 2000-2001, and an additional credit of \$181 million for fiscal year 2001-2002.

<u>Summary of Savings Reserve Account (in millions) :</u>			Increase/ (Decrease)	Balance
Date		Description		
		Reserve - Budget Stabilization		
		(Rainy Day Fund).....	\$ 0.4	\$ 0.4
June	1992	Statutory Reservation - G. S. 143-15.3	41.2	41.6
June	1993	Statutory Reservation - G. S. 143-15.3	134.3	175.9
July	1993	Withdrawal from Reserve.....	(121.0)	54.9
June	1994	Statutory Reservation - G. S. 143-15.3	155.7	210.6
January	1995	Budget Stabilization Appropriation	66.7	277.3
June	1995	Statutory Reservation - G. S. 143-15.3	146.3	423.6
June	1996	Statutory Reservation - G. S. 143-15.3	77.3	500.9
June	1997	Statutory Reservation - G. S. 143-15.3	—	500.9
June	1998	Statutory Reservation - G. S. 143-15.3	21.6	522.5
June	1999	Statutory Reservation - G. S. 143-15.3	—	522.5
July	1999	Withdrawal from Reserve.....	(200.0)	322.5
January	2000	Withdrawal from Reserve.....	(286.0)	36.5
June	2000	Statutory Reservation - G. S. 143-15.3	1.0	37.5
June	2001	Appropriation	\$ 120.0	\$ 157.5

General Fund Budgetary Shortfall

Fiscal Year 2000-2001

The June 30, 2000, CAFR transmittal letter issued in early December 2000, described the beginnings of the General Fund budgetary pressures which contributed to the General Assembly's longest legislative session (*January to December*) in our State's history. By November 2000, it was apparent that State revenues were reflecting a slowdown in the State's economy.

Governor Easley took office in January 2001, and quickly began to address the revenue shortfall by ordering agency budget reductions, diverting dollars from special funds to the General Fund, delaying employer (State) retirement contributions from the General Fund, and delaying reimbursements from General Fund corporate income tax receipts to local governments.

By June 30, 2001, the General Fund revenues, including tax, non-tax, diverted funds, and delayed reimbursements, fell short of estimated revenue by \$598.4 million. Individual income tax fell short of estimates by \$259.4 million, sales and use tax payments fell short of estimates by \$177.7 million, and corporate income and franchise tax payments fell short of estimates by \$149.3 million. With lowered available investment balances in the General Fund, investment earnings fell short of estimates by \$43.1 million. With zero beginning availability, there were a nearly like amount of appropriation expenditure reductions totaling \$604.6 million. The largest

budget reductions were absorbed by the Department of Public Instruction, \$120.7 million (2.1%); the Department of Community Colleges, \$19.4 million (3%); the University of North Carolina System, \$33.8 million (1.9%); the Department of Health and Human Services, \$78.6 million (2.5%); and the Department of Correction, \$28.4 million (3.1%). These five entities account for approximately 87% of the State's General Fund budget and actual appropriation expenditures. Several general government and administrative agencies experienced budget reductions on the order of 10 to 22%.

Included in the General Fund cash reserves at June 30, 2001, was the delayed reimbursement to local governments which has now been distributed. On July 10, 2001, \$95.087 million was distributed to local governments.

As of June 30, 2001, \$129.9 million of the \$212.5 million owed to the State's retirement systems was used to fund the General Fund budget shortfall. On December 6, 2001, legislation expressing the intent of the General Assembly to repay \$129.9 million of retirement contributions plus interest over a five-year period beginning July 1, 2003, was approved and forwarded to Governor Easley for signature. On December 7, 2001, the remaining \$82.6 million was forwarded to the various retirement systems administered by the State Treasurer.

Fiscal Year 2001-2002

On September 26, 2001, Governor Easley signed the appropriations budget for fiscal year 2001-2002. The newly adopted appropriations act included tax increases for sales and use tax and individual income tax, as discussed earlier, and assumed baseline revenue growth of 4%.

General Fund revenue collections have lagged expectations so far in fiscal year 2001-2002. General Fund tax and non-tax revenues are \$195.5 million behind projections through November 30, 2001, and are expected to be short of projections by \$450 million to \$900 million at June 30, 2002. Current estimates for Medicaid services for fiscal year 2001-2002 indicate a shortfall of between \$100 million to \$109 million through November 30, 2001. Therefore, the General Fund budget may experience a budget shortfall comparable to the 2000-2001 fiscal year. The General Fund budget will be balanced at the end of the fiscal year ending June 30, 2002.

The Office of State Budget and Management has implemented a plan to cover the budgetary shortfall. Unaudited, General Fund budgetary financial information is available on the State's web page at: <http://www.osc.state.nc.us/financial/>.

Other Funds

Proprietary Funds

Operating revenues and operating expenses for the State's enterprise funds were \$32.9 million and \$129.55 million, respectively, in 2001. Operating loss was \$96.6 million, with the majority of the loss reflected in the Child Health Insurance Program at \$99.7 million. This loss is largely offset by nonoperating federal grants of \$74.7 million and operating transfers-in of \$23.2 million. The Public School Insurance Fund, experienced operating income of \$3.1 million in fiscal year 2000-2001, based on claims expenses of \$1.86 million. Claims expenses for fiscal year 1999-2000 were \$19.6 million. Excessive claims for fiscal year 1999-2000 were the result of damages sustained by public schools as a result of Hurricane Floyd as it passed through eastern North Carolina in September 1999.

Combined operating results for the State's internal service funds exhibited continued strength in 2001. Operating revenues and expenses for these cost-reimbursement funds totaled \$375.05 million and \$361.9 million, respectively, in 2001. Net operating income was \$13.1 million for fiscal year 2001. Principal internal service fund operations include the Workers' Compensation Program, Death Benefit Plan, Prison Enterprises, the State Property Fire

Insurance, Motor Fleet Management, Centralized Computing Services, and State Telecommunications.

Pension Trust Funds

The State contributes to the Teachers' and State Employees' Retirement System, the Consolidated Judicial Retirement System, the Legislative Retirement System, the Firemen's and Rescue Squad Workers' Pension Fund, the Supplemental Retirement Income Plan of North Carolina, and the North Carolina National Guard Pension Fund. The Local Governmental Employees' Retirement System is administered by the State but the State is not a participant.

At June 30, 2001, the pension trust funds experienced a decline in total investment balances of \$2.265 billion, or 3.7% from the prior fiscal year. Total employer contributions declined \$420 million, or 42% from the prior fiscal year. The funds also suffered a net investment income loss of \$1.398 billion, which represented a \$6.645 billion, or 126.7% decline from fiscal year 1999-2000.

In the Teachers' and State Employees' Retirement System, the largest of the pension trust funds, employer contributions decreased by \$430.6 million, or 58.2% from the prior fiscal year. Investment balances declined by \$1.96 billion, or 4.2% from the prior fiscal year, with a net investment income loss of \$1.08 billion representing a decline of \$4.988 billion, or 127.6 % from the prior year. The system experienced a 10.9% increase in benefit payments to participants. However, the Teachers' and State Employees' Retirement System continues to be fully funded.

For the fiscal year ended June 30, 2001, the decline in contributions was primarily attributable to budgetary pressures on the State's General Fund. These pressures resulted in the State being unable to fully fund its actuarial required contribution to the Teachers' and State Employees' Retirement System, the Consolidated Judicial Retirement System, the Legislative Retirement System, and the Firemen's and Rescue Squad Workers' Pension Fund. Investment and investment income declines were attributable to market and economic downturns.

Debt Administration

At June 30, 2001, the State had a number of debt issues outstanding. These issues included \$3.039 billion in general obligation bonds, \$2.132 billion in revenue bonds in the component unit proprietary funds and \$1.3 billion in revenue bonds in the university funds. North Carolina continues to have AAA bond ratings, the highest ratings attainable, issued by Standard and Poor's Rating Services, Moody's Investors Service, and Fitch, Inc.. These favorable ratings have enabled the State to sell its bonds at interest rates considerably below the Bond Buyer's Index, thereby providing substantial savings to North Carolina taxpayers. North Carolina is one of only a very small number of states currently having the AAA ratings. In addition, approximately 25 percent of all AAA ratings for state and local governments nationwide are located in North Carolina.

Cash Management

It is the policy of the State that all agencies, institutions, departments, bureaus, boards, commissions and officers of the State shall devise techniques and procedures for the receipt, deposit and disbursement of monies coming into their control and custody which are designed to maximize interest-bearing investment of cash, and to minimize idle and nonproductive cash balances. The State Controller, with the advice and assistance of the State Treasurer, the State Budget Officer, and the State Auditor, develops, implements, and amends the *Statewide Cash Management Policy*. All cash deposited with the State Treasurer by State entities is managed in pooled investment accounts to maximize interest earnings. During fiscal year 2001, uncommitted State funds were invested in short-term and medium-term U.S. Government notes and bonds, as well as other deposits, which had a composite average yield of 6.054%.

Risk Management

The State has a limited risk management program for fire and other property losses. As part of this comprehensive plan, resources are being accumulated in an internal service fund to meet potential losses. See **Note 12** of the Notes to the Financial Statements for a full description of the State's risk management program.

Other Information

Independent Audit

In compliance with State statute, an annual financial audit of the State entity is completed each year by the North Carolina Office of the State Auditor. The Auditor's examination was conducted in accordance with generally accepted government auditing standards and his opinion has been included in this report. In addition, the State coordinates the *Single Audit* effort of all federal funds through the State Auditor.

Certificate of Achievement

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the State of North Carolina for its comprehensive annual financial report (CAFR) for the fiscal year ended June 30, 2000. The Certificate of Achievement is a prestigious national award recognizing conformance with the highest standards for preparation of state and local government financial reports.

In order to be awarded a Certificate of Achievement, a government unit must publish an easily readable and efficiently organized comprehensive annual financial report, whose contents conform to program standards. The CAFR must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe our current report continues to conform to the Certificate of Achievement program requirements, and we are submitting it to GFOA.

Acknowledgments

In conclusion, we believe this report provides useful data to all parties using it in evaluating the financial activity of the State of North Carolina. We in the Office of the State Controller express our appreciation to the financial officers throughout State government and to the Office of the State Auditor for their dedicated efforts in assisting us in the preparation of this report. Any questions concerning the information contained in this Comprehensive Annual Financial Report should be directed to the Office of the State Controller at (919) 981-5454.

Respectfully submitted,

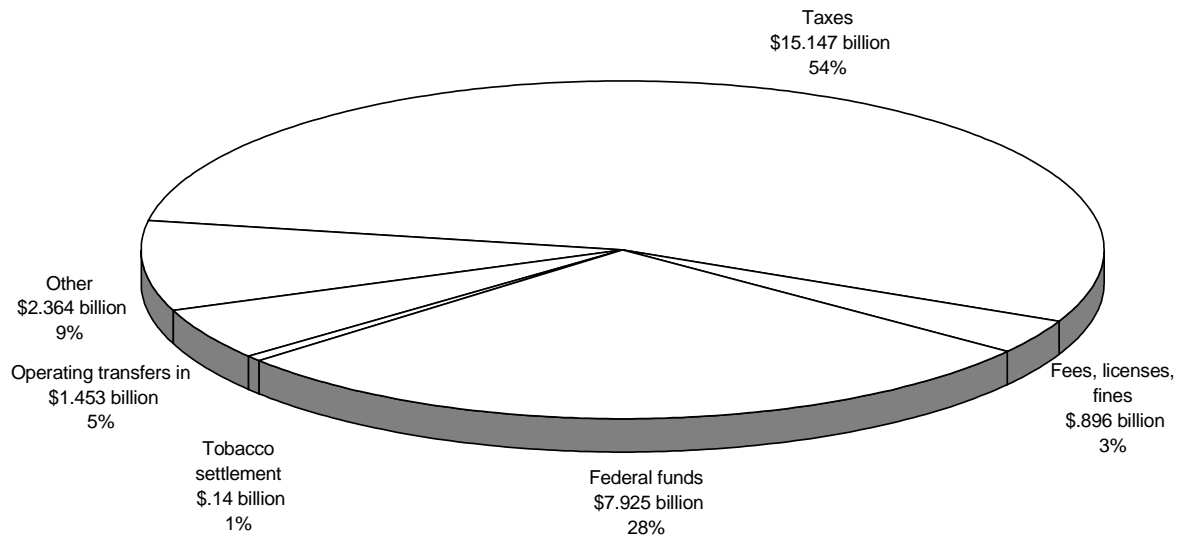


Robert L. Powell
State Controller

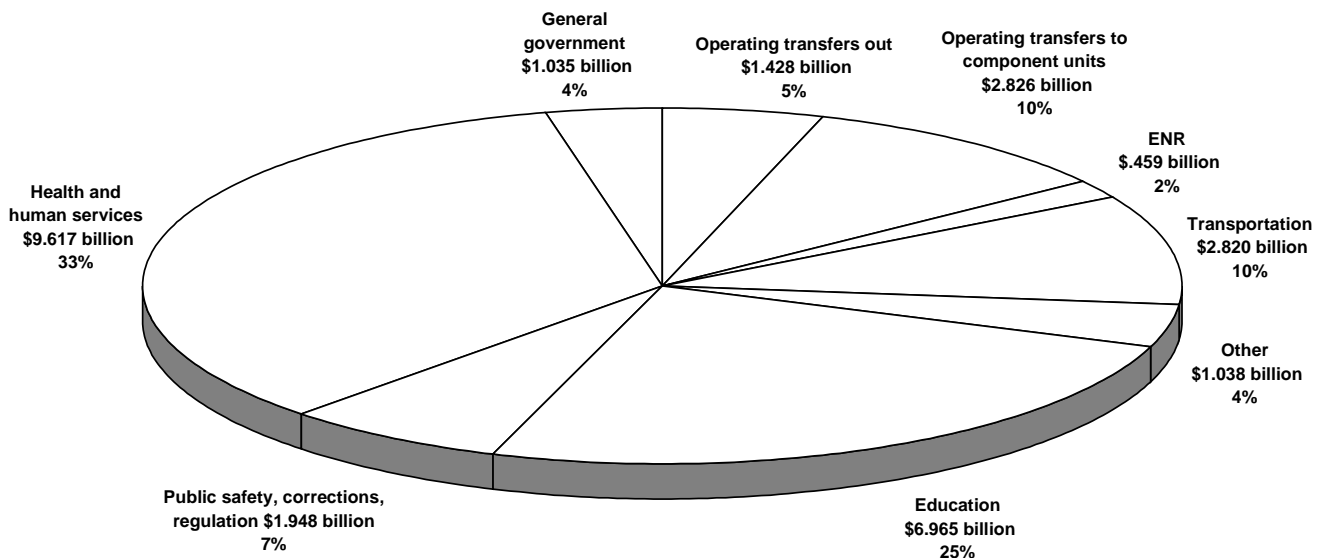
December 7, 2001

General Governmental
General, Special Revenue, and Capital Projects Funds
For the Fiscal Year Ended June 30, 2001

Revenues and Other Financing Sources
\$27.925 billion



Expenditures and Other Financing Uses
\$28.136 billion



CERTIFICATE OF ACHIEVEMENT

Certificate of Achievement for Excellence in Financial Reporting

Presented to

State of
North Carolina

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
June 30, 2000

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



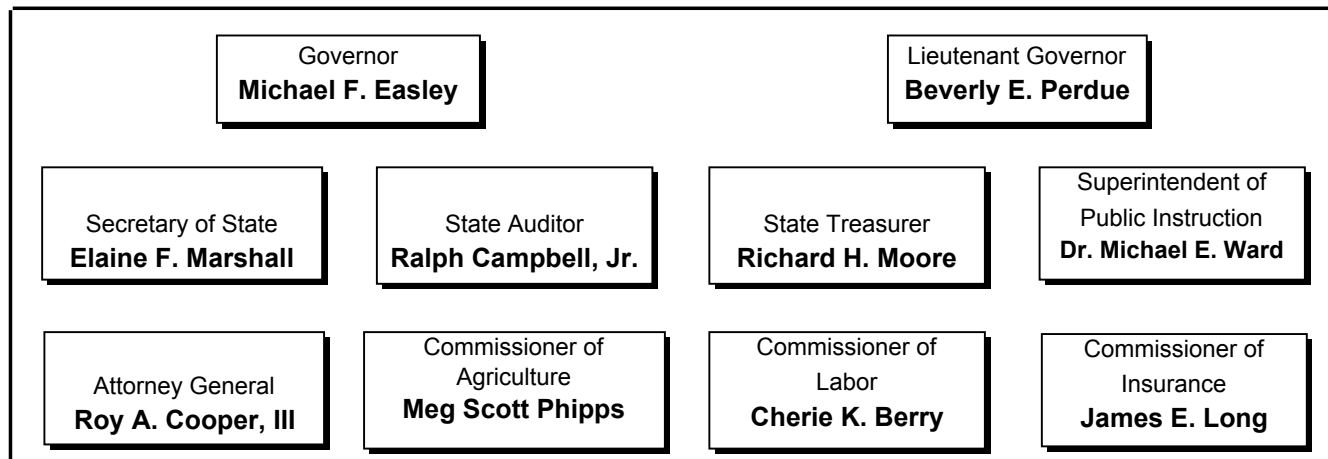
Donald A. Brown
President

Jeffrey L. Esser
Executive Director

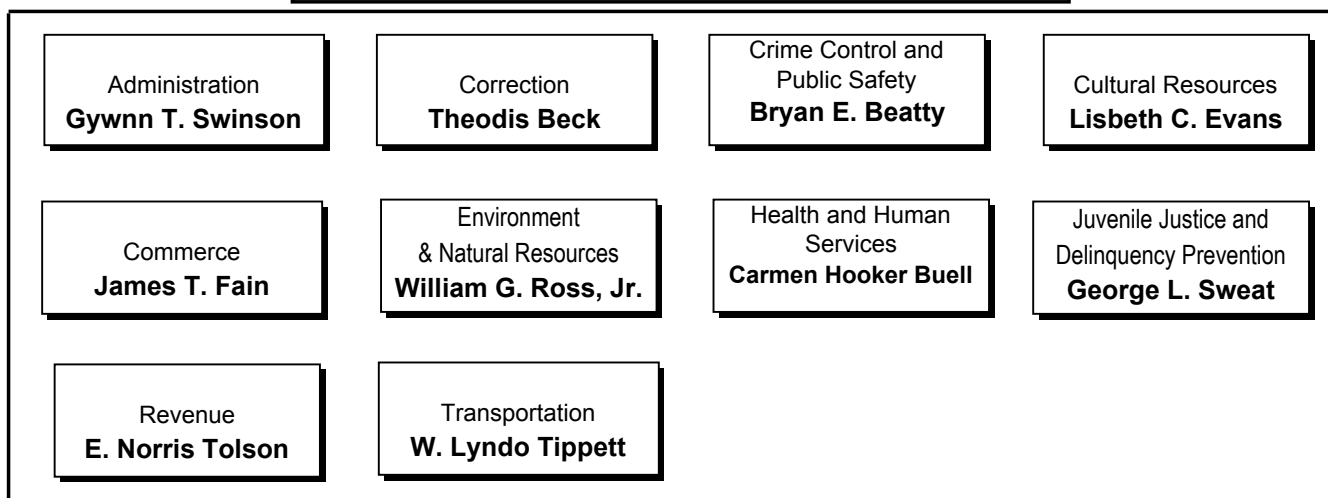
ORGANIZATION OF NORTH CAROLINA STATE GOVERNMENT INCLUDING PRINCIPAL STATE OFFICIALS

EXECUTIVE BRANCH

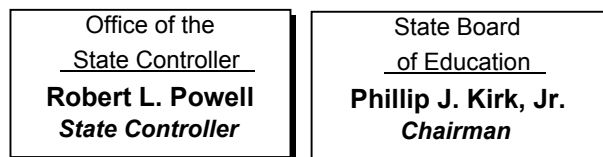
Council of State



Cabinet Secretaries — Appointed by the Governor



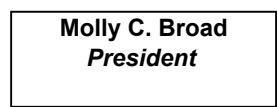
Appointed by Governor, confirmed by Legislature



Appointed by State Board of Community Colleges



Appointed by University Board of Governors



LEGISLATIVE BRANCH**General Assembly****Senate**

President
Lieutenant Governor

President Pro Tempore
Marc Basnight

Deputy Pres. Pro Tempore
Frank W. Ballance, Jr.

Majority Leader
Tony Rand

Minority Leader
Patrick J. Ballentine

**House of
Representatives**

Speaker
James B. Black

Speaker Pro Tempore
Joe Hackney

Majority Leader
Philip A. Baddour

Minority Leader
N. Leo Daughtry

JUDICIAL BRANCH**North Carolina
Supreme Court**

Chief Justice
I. Beverly Lake, Jr.

Associate Justices
G. K. Butterfield, Jr.
Robert H. Edmunds, Jr.
Robert F. Orr
Mark D. Martin
Sarah Parker
George L. Wainwright, Jr.

Administrative
Office of the Courts
Judge Robert H. Hobgood
Director

Component Units**University of North Carolina System****Golden LEAF****Community
Colleges****Proprietary
Funds****NC Phase II Tobacco
Certification Entity**